

**Memorandum**To: Mr. Dick Johnson (M12.64)RECEIVED
Date: April 29, 1996

APR 30 1996

From: Eric F. Eisenlauer

Division of Assessment Standards
SACRAMENTOSubject: Possessory Interests in P.E.R.S. Properties

This is in response to your memorandum to Mr. Larry Augusta of March 8, 1996 in which you request that we provide you with a legal opinion regarding the proper assessment of taxable possessory interests in investment properties purchased by P.E.R.S.. You request that we revisit the issue because, in your view, it "has apparently never been settled."

The issue is whether the possessory interests of tenant lessees in privately-owned investment real property are to be appraised as taxable possessory interests at current market value upon the acquisition of the real property by P.E.R.S., a tax exempt public entity. In other words, is the acquisition by P.E.R.S. the "creation...of a taxable possessory interest in tax exempt real property" and thus a change in ownership for purposes of Revenue and Taxation Code section 61(b) requiring each taxable possessory interest thereby created to be appraised at current market value?

The Board's Letter to Assessors dated January 6, 1983 (LTA 83/03) seems to take the position that such an acquisition does constitute the creation of taxable possessory interests for purposes of section 61(b). Assuming for the sake of argument that it does, Chief Counsel Jim Delaney took issue with that conclusion, among others, in LTA 83/03, in a memorandum to Larry Augusta dated December 19, 1983 stating:

The conclusion that a possessory interest is created as of the date it becomes separately assessable is bothersome. A tenant's interest in any facility is always taxable unless specifically exempted, otherwise the landlord could not be assessed for its value. While the language of Revenue and Taxation Code Section 61(b) provides that the creation of a taxable possessory interest constitutes a change in ownership, it does not provide that the sale to an exempt governmental entity of a reversionary

interest in property subject to a lease creates a taxable possessory interest. While such a sale results in separate assessment of the possessory interest, there is no change in the ownership of that interest nor is the interest created by the sale of the pre-existing reversionary interest.

Bob Keeling revisited the issue in a memorandum to Verne Walton dated September 23, 1988 and agreed with the Delaney conclusion stated above. Bob's memorandum states:

When a retirement system purchases property for investment purposes, which property has tenants in occupancy, the calculation of the value of the tenant's interest should not be based on the market value of the property at the time of the purchase. The system would take the property subject to the lease(s). The leases would not change ownership until the new owner negotiated a renewal, sublease or assignment with the existing tenants or created new possessory interests. Since the tenant's interests have not changed ownership there is no basis of reappraising those interests. They should be assessed at the value that they would have been assessed at had they been taxable possessory interests at the time of the system purchase.

* * *

We recommend you disregard the provisions of Assessors' Letter 83/03 and the contents of Mr. James J. Delaney's memorandum of December 19, 1983, to the extent that either is inconsistent with the conclusions reached hereinabove. The discussion herein was reached after discussions with Mr. Delaney and with your division, so no useful purpose would be had by analyzing or commenting upon irrelevant portions of either Assessors' Letter 83/03 or Mr. Delaney's memorandum of December 19, 1983.

The quoted conclusions of the Delaney and Keeling memoranda, i.e., that taxable possessory interests are not created for

purposes of section 61(b) when a leased income property is acquired by P.E.R.S. appeared in the Board's 1990 Assessment Practices Survey entitled "A Report on Section 11 and PERS Properties" which stated at page 13:

The value of the possessory interest is based on the rental agreements in effect when the income property is purchased by the retirement system. When the existing leases are renewed, subleased or assigned, a new possessory interest value will be established since a change in ownership of the possessory interest has occurred.

Based on the foregoing, we disagree with your conclusion that the issue has never been settled. It is clear to us that the issue has been settled and that the notion that the acquisition of leased income property by a public retirement system creates taxable possessory interests for purposes of section 61(b) was rejected by the Chief Counsel and legal staff after devoting considerable attention to the issue. In our view, no useful purpose would be served by again revisiting this question.

Gerie F. Eisenbauer

EFE:ba

cc: Mr. Jim Speed - MIC:63
Ms. Jennifer Willis - MIC:70

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No. 83/03

January 6, 1983

TO COUNTY ASSESSORS:

REAL PROPERTY ACQUIRED BY PUBLIC RETIREMENT SYSTEMS

We have recently had several inquiries into the status of public retirement systems. Of the 58 counties in California, 23 of them either have no retirement systems or have established their own local employees' retirement systems, while the remainder of the counties are members of Public Employees Retirement System (State of California); in addition, various cities and special districts throughout California have established retirement systems for their employees. Several of these systems have purchased real property with their retirement assets for investment purposes. The purpose of this letter is to recommend how such real property should be treated for property tax purposes.

A public retirement system is usually an agency of the government whose employees contribute earnings to the system's fund. Accordingly, real property acquired by such a system should be treated the same as real property acquired by any other government entity. If the property acquired is located within the boundaries of the retirement system (i.e. city or county limits), it will become exempt from taxation pursuant to Article XIII, Section 3(b) of the California Constitution. If the property is located outside the local government boundaries, there shall be an assessment pursuant to Article XIII, Section 11.

Section 11 Requirements

Article XIII, Section 11 requires that land located outside Inyo or Mono counties and taxable when acquired by a local government must be assessed at the lower of its fair market value or a figure equal to the 1967 assessed value multiplied by the Phillips factor. This factor, published annually by this Board, is obtained by first dividing the current year's total assessed value of land only by the July 1 civilian population count, then dividing this result by \$856 for the 1967 factor.

Improvements that were taxable when acquired, and replacement improvements built before March 1, 1954 remain taxable at the lower of their current fair market value as defined in Section 110 of the Revenue and Taxation Code or their full cash value as defined in Section 110.1.

Replacement improvements built after March 1, 1954 must be assessed at the lowest of the Section 110 value, the Section 110.1 value, or the highest assessed value ever used for the replaced improvements. All improvements built after acquisition which are not replacements of pre-existing taxable improvements are exempt from taxation.

It is unlikely that any local retirement system would acquire land located outside its boundaries and subsequently construct improvements thereon. The instances we have seen of purchases of real property by local public retirement systems involved only improved commercial properties that were already generating income. Such acquisitions fulfill the investment objectives of the local retirement system.

The Creation of Taxable Possessory Interests

The acquisition of real property by a tax exempt public agency opens the possibility that there will be taxable possessory interests in the property. The private possession of the exclusive right to the beneficial use of publicly owned real property constitutes a taxable possessory interest. Examples of such interests include the occupancy of office space in a commercial building purchased for investment purposes by a public retirement system.

We feel that the date of valuation of pre-existing rights of possession should be the date the real property was acquired by the public retirement system, for it was at this time that such possessory interests became taxable. Section 61(b) of the Revenue and Taxation Code clearly states in part that a change in ownership occurs upon the creation of a taxable possessory interest in tax exempt real property for any term. In this case, the fee simple rights in the real property had previously been assessed to the owner of record; however, when the fee became exempt because a tax exempt public agency acquired the property, the right of exclusive occupancy held by the tenant/lessee became a taxable possessory interest. Therefore, such pre-existing possessory interests should be appraised as of the date they became taxable, i.e. the date of the transfer of the real property to the public retirement system; notwithstanding that such interests may have been created prior to this transfer.

Of course, taxable possessory interests in real property can be created after the acquisition of the property by the public retirement system. For instance, if a retirement system, as lessor of a recently purchased office building, executes new leases or renews existing leases of space in the building to private parties, such actions constitute changes in ownership. The taxable possessory interests so created must therefore be valued as of the date of the lease or date of renewal.

Effects of AB 662

AB 662, which was chaptered as Chapter 24 of the Statutes of 1982 in February of 1982 (see Legislative Summary No. 3, dated March 12, 1982), added Section 7510 to the Government Code. This section requires public retirement systems to reimburse cities or counties for revenue loss resulting from their acquisition of real property in an amount equal to the difference between the taxes that would have accrued and the taxes due for possessory interests in the acquired property. If the public retirement system acquired property within its boundaries—for example, if P.E.R.S. or the State Teachers Retirement System purchased real property anywhere in California—this property would become exempt from taxation, except for private possessory interests resulting from the acquisition by a public agency (e.g., lessees in an office building).

We are of the opinion that the taxes that would have accrued should be based on the current market value of the property at the time of its acquisition by the public retirement system. The in-lieu fee is the difference between the taxes based on this current market value and the possessory interest taxes. In essence, the county is thereby guaranteed that the acquisition of real property within the county by a public retirement system will not cause a decline in tax revenue below the level that would have prevailed had the acquiring person or entity been taxable.

If the public retirement system acquires real property outside its boundaries, the property will not be removed from the local secured assessment roll, but will instead become subject to the restricted valuation prescribed by Section 11. In this case, the retirement system pays no in-lieu fee to the city or county, since the real property acquired continues to be assessed. The intent of Article 13, Section 11 was to reduce the erosion of the local tax base due to the acquisition of real property by tax-exempt public agencies, where the real property so acquired was located outside its boundaries. AB 662 acts similarly by guaranteeing that when a public retirement system acquires real property located within its boundaries, there will be no loss of tax revenues to the local government.

The following examples illustrate how Section 7510 applies to purchases of real property by public retirement systems.

Example 1: Public Employees' Retirement System (State of California) purchases an existing office building and land in your county. The factored base year value of the property is \$300,000. P.E.R.S. paid \$450,000 for the property, which agrees with your appraisal of the current market value of the property as of the date of transfer. Your county correctly exempts this property from taxation under Article XIII, Section 3(b). There are private tenants in this building whose

TO COUNTY ASSESSORS

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January 6, 1983

taxable possessory interests are valued at \$50,000. What would P.E.R.S.'s liability be?

$$\$450,000 - \$50,000 = \$400,000 \times \text{Tax Rate} = \text{in-lieu fee to be paid by P.E.R.S.}$$

Example 2: A county employees' retirement system purchases commercial real property in your county, which is outside its (the retirement system's) boundaries. This property, for which the retirement system paid \$500,000, had a base year value of \$300,000 prior to the purchase. Private taxable possessory interests in this property amount to \$40,000. Under Article XIII, Section 11, the land value is determined to be \$117,902 (1967 assessed value of \$10,000 x 1982 Phillips factor 11.79023). The market value of the improvements pursuant to Section 110 is estimated to be \$400,000 and their factored base year value is \$250,000. What would be the liability of the local retirement system?

\$117,902
250,000
\$367,902

Land
Improvements
Total assessed to local retirement system

In addition, there would be possessory interest assessments totalling \$40,000 assessed to the holders of such interests. The aggregate total of the Section 11 value and the possessory interest values may not exceed the current market value of the fee simple interest in real property, pursuant to subdivision (f) of Article XIII, Section 11.

Section 7510 of the Government Code does not apply to local public retirement systems that are already authorized by statute or ordinance to invest in real property. This exclusion directly affects several county employees' retirement systems that already hold real estate investments. We advise you to investigate your own county retirement system, if your county does not belong to P.E.R.S., to determine whether it is authorized to invest retirement assets in real estate.

If you have any questions concerning either the property tax status of public retirement systems or AB 662 (copy enclosed), please direct them to our Technical Services Section.

Sincerely,

Verne Walton

Verne Walton, Chief
Assessment Standards Division

VW:bjb
Enclosure
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